

Greece and the euro: decision time

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Q&A

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Luca Paolini, Chief Strategist

The fate of a nation will be decided on July 5, when Greece holds a referendum that could lead to its exit from the euro zone. In this Q&A, Luca Paolini gives his view on how events are likely to unfold and sets out what investors should look out for.

 **With Greece certain to default on a EUR1.5 billion debt payment to the IMF and its banks denied additional emergency assistance from the European Central Bank, is the country destined to exit the euro whatever the outcome of Sunday's referendum?**

L.P. No, but the probability of the country's exit from the euro zone has risen significantly. The default on the IMF debt payment is all but certain (even though it will likely be labelled a "delay").

The critical deadline, however, is July 20, when Greece is due to make a EUR3.5 billion debt repayment to the ECB.

In the absence of a finance-for-reform agreement before then, a default on ECB-held debt will be unavoidable and could prove the trigger for Greece's disorderly exit from the euro zone. A slightly more favourable scenario would see the creation of domestic parallel currency that would allow Greece to remain within the euro zone, although it is difficult to see how sustainable such a situation could be over the longer run.

The Greek referendum on the financing package proposed by the ECB/EU Commission/IMF – which is in effect a referendum on euro membership – complicates matters enormously.

The most troubling outcome would be a 'no' vote. Under this scenario, the ECB would cut off Greek banks from its emergency lending facility; Greek government bonds would no longer be accepted as collateral. This would entail a Greek debt default and lead to the country's rapid exit from the euro zone. The potential for bank failures would rise, creating economic and political uncertainty that could spread beyond Greek borders.

Yet a 'yes' vote would not necessarily lead to a quick resolution. Although an endorsement of the new bailout package would, at first sight, give Greece another opportunity to secure an agreement with its creditors, it could just as easily create more political uncertainty.

The Syriza-led government's position in the event of a 'yes' vote remains unclear, and there is no guarantee the Troika would wish to engage in negotiations with the Greek prime minister Alexis Tsipras, with whom relations are tense. Trust is in extremely short supply.

In our view, the most positive – and most likely – scenario is a 'yes' vote coupled with the formation of a new, broader governing coalition with whom the IMF and euro zone policymakers can more easily negotiate.

This could potentially result in a less restrictive finance package that would offer Greece some debt relief.

It is worth pointing out that the US appears to be putting pressure on Germany to keep Greece within the euro zone and offer the country more wiggle room. The Obama administration is clearly concerned at the prospect of political instability in Southern Europe and wants to avoid this at all costs.

As things stand, opinion polls suggest the Greek population will vote in favour of the creditor proposal by a wide margin. But, with those polls having been conducted before the Syriza government said it would campaign for a 'no' vote, the outcome could turn out to be much closer.

Have bond and equity markets sufficiently discounted the consequences of Greece's potential exit from the euro zone?

L.P. Euro zone equity markets have fallen by about 10 per cent since mid-April while yield spreads on government bonds issued by the countries in the region's periphery (Italy, Spain) have almost doubled over that time. The yield differential between Italian 10-year BTPs and German Bunds, for instance, has widened from 88 basis points to just under 160 basis points.

This relatively muted market reaction indicates the investment community has faith in euro zone policymakers' capacity to contain the fallout from a Greek exit. This is our view too. Indeed, we believe the recent decline in both European stocks and peripheral government bond markets presents a buying opportunity for investors. Of course, a disorderly Greek exit from the euro has the potential to precipitate a sell-off in the bond and equity markets of Italy and Spain in the short term. Investors will at this point try to quantify redenomination risk, or the possibility that these countries will also one day splinter away from the single currency region. Over time, however, we are confident that euro zone governments and the ECB will act decisively to put such fears to rest.

What actions can euro zone authorities take to assure financial markets that the region's other heavily indebted nations will not suffer the same fate as Greece should it exit the single currency? Can investors really believe that Mario Draghi will still do "whatever it takes" to save the euro?

L.P. The ECB's pledge to do whatever it takes to safeguard the euro is credible – quantitative easing is already in progress, and the central bank can increase the programme's size as well as concentrate purchases in longer-duration securities. This is what we believe would happen in the event of a Greek departure. The Outright Monetary Transactions scheme (the ECB's programme of purchasing sovereign bonds of countries committing themselves to a reform agenda) is also an option and the European Court of Justice has recently ruled the programme to be lawful, giving the central bank ample room to intervene in the secondary bond markets.

Additionally, the euro zone still has some EUR450 billion of unused funds at its disposal under the European Stability Mechanism, which can also be rapidly deployed. What is more, the provisions of the newly established

euro zone wide banking union should prevent contagion among the banks in the single currency zone.

There is also the possibility that, in the event of significant market and economic stress, the austerity measures (i.e. government budget targets) will be relaxed to some extent by the European finance ministers. This would be easier to do for countries such as Italy and Spain as both Rome and Madrid governments are now delivering on structural reforms.

Would a Greek exit from the single currency ultimately make the euro zone more financially stable?

L.P. Yes, in the medium term, for two reasons. First, it will force euro zone policymakers to deepen financial and fiscal integration at a faster pace in order to ring-fence countries that are implementing structural reforms.

Second, a Greek departure will show euro zone governments and their electorates that the economic pain of casting aside reform would be too great to bear.

In this respect, we believe that a Greek exit will strengthen the position of pro-reform governments as austerity and structural change would be considered the only viable solution to cutting debt. This theory could be put to the test as soon as November this year, when Spain heads to the polls.


In the longer-term, a major risk for the euro zone is that Greece manages to thrive outside it. In this case, governments of heavily-indebted economies such as Italy may be tempted to go down the same route (and their electorates may see this as a way out of economic misery). This is an unlikely scenario, however.

Will this potential fracture of the euro zone make the US Federal Reserve think twice about raising interest rates this year?

L.P. No. Unless Greece's departure triggers a significant global market sell-off that could endanger the US economy and/or put upward pressure on an already strong US dollar (which in turn will raise the risk of deflation), the Fed will raise rates this year.

We continue to believe the Fed will hike rates in December this year at the latest. Our central scenario is for a September/October rate hike.

The developments in Greece will have a much bigger impact on countries that are economically more dependent on the euro zone. The Swiss central bank has intervened in currency markets in recent days to stop the Swiss franc appreciating against the euro, apparently targeting a floor of CHF1.03. Meanwhile, with sterling close to its highest level against the euro since 2007, the Bank of England may decide to postpone its first rate hike until a resolution of the Greek saga is in sight.

 **Given that your base case scenario envisages a 'yes' vote coupled with the formation of a broader governing coalition that is better placed to negotiate with Greece's creditors, how do you see the investment landscape evolving over the short and the medium term?**

L.P. Markets are likely to remain very volatile at least until the outcome of the Greek referendum is known. In case of significant market turbulence, we would look to increase exposure to banks based in Italy, Spain and Portugal and add to our holdings of long-dated government bonds issued by these countries. We are neutral on the euro but we believe any downward move in the currency is likely to be short-lived. Investor positioning in the euro is exceptionally bearish and the currency looks deeply undervalued. Our models indicate the euro is 20-25 per cent below its fair value against the US dollar. In the event of a 'no' vote, it is not clear the euro would weaken. A Greek exit could feasibly boost the euro as investors could see the removal of the euro zone's weakest link as a reason to buy.

If the referendum outcome delivers a 'yes' vote, the medium term outlook for euro zone asset classes will be positive. We continue to believe that the fundamental case for euro zone equities is very solid. Economic growth in the region is running at about 2 per cent and liquidity conditions are extremely supportive. Not only does the export-dependent region benefit from a cheap currency but its companies are delivering solid earnings growth, which are this year expected to rise some 14 per cent. True, valuations for euro zone stocks are not cheap at 14.5 times 12 month forward earnings. Yet corporate profits remain 35 per cent below their previous peak so from that perspective, there is plenty of upside. We are overweight European equities in our tactical allocation grid. We are also constructive on Southern European sovereign bonds, given that we expect limited fallout from Greece, and in the light of the recovery gaining momentum in the region's periphery.

European high-yield bonds look vulnerable. The market has been remarkably resilient during this period

of market turbulence, which looks unsustainable. What is more, with investor positioning in the asset class at bullish levels and secondary market liquidity deteriorating, speculative-grade bonds could suffer disproportionately in the event of renewed uncertainty.

Over the long term, we do not believe a Greek exit – if it occurs – will have a significant effect on our forecasts for euro zone stocks; we expect them to generate a 5 per cent yearly gain through to 2020. We also see the euro appreciating considerably against the US dollar over the next five years.

Luca Paolini, Chief Strategist

Luca Paolini joined Pictet Asset Management in 2012 as Chief Strategist.

Before joining Pictet, Luca worked as an Equity Strategist at Credit Suisse Securities, responsible for asset, regional and sector allocation. From 2005 to 2007, he was Investment Strategist at Union Investment. Luca started his career in 2001 at Allianz Dresdner Asset Management as a assistant vice president, covering asset allocation and investment strategy.

Luca holds a Master degree in International Economics and Management from SDA Bocconi School of Management in Milan, and a Laurea Magistrale in Political Sciences from the University of Bologna.

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Composed of macroeconomists, quantitative analysts and representatives from PAM's equity and fixed income investment teams, the PSU builds an asset allocation framework through its analysis of economic conditions, market valuations and technical factors such as market liquidity.

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